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ABSTRACT

Until the beginning of 1994, federal law permitted mandatory retirement of tenured faculty at age 70. The Committee on Mandatory Retirement in Higher Education, formed by the National Research Council, was charged by Congress to examine potential effects on colleges, universities, and faculty members of ending the exemption for tenured faculty under the Age Discrimination in Employment Act. The committee concluded that at most colleges, few faculty would work beyond age 70 but that a proportion at research institutions would continue, and that pension design could help institutions cope with this situation. The committee strongly recommended that institutions consider re-designing pension plans, institute a range of income replacement ratios and benefits related to service, and address the issues of benefit portability and normal retirement age. The committee stressed the importance of maintaining the purchasing power of retirement income, possible through a variety of annuity payment methods such as graded payment and variable annuity accounts. In response to administrator concerns about rising costs, placing limits on benefits was proposed. Voluntary retirement incentives that reduce overstaffing, control costs, and offer flexibility for partial or phased retirement were suggested. The role of health insurance availability and cost in retirement decisions was also considered, and institutional assistance to faculty in planning retirement and maintaining links with the academic community were recommended. (MSE)

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Pension Design in the Post-Mandatory Retirement Era

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This issue of Research Dialogues *is the second of two devoted to pension plan design. Taking a long-term view, the previous issue discussed demographic developments that can affect pensions as we move into the twenty-first century. This issue addresses a more immediate challenge to pension design: adjustment to the end of mandatory retirement of tenured faculty.*

Until the beginning of this year, federal law permitted mandatory retirement of tenured faculty at age 70. This was based on an exception included in 1986 amendments to the Age Discrimination in Employment Act, which eliminated mandatory retirement for most other employees in the United States. Congress allowed the exception to expire following a recommendation by the Committee on Mandatory Retirement in Higher Education of the National Research Council, which had been designated by Congress to study the issue.

For all institutions of higher education, regardless of specific faculty age profiles, the Committee on Mandatory Retirement presented a number of recommendations on pension plan design for the post-mandatory retirement era. This issue of Research Dialogues *reviews their recommendations.*

Background of Federal Age Discrimination Law

Under the Age Discrimination in Employment Act of 1967 (ADEA), age 65 became the earliest age permitted for mandatory retirement for most employees. Because 65 was already a conventional mandatory age in educational institutions, the 1967 law did not greatly change educational practice. But beginning a decade later, further ADEA changes were made, first in 1978, raising the earliest mandatory retirement age to 70, and then in 1986, eliminating ("uncapping") mandatory retirement for virtually all employees.

Both amendments, however, incorporated exceptions for tenured faculty. The 1978 exception allowed tenured employees to be retired at age 65 instead of 70 through June 30, 1982, a period of four and a half years. The 1986 exception allowed continued mandatory retirement at age 70 for tenured employees through December 31, 1993, a seven-year period. Use of the exception was optional for employers; over these years some colleges voluntarily uncapped their retirement age provisions, and some states passed preempting laws that eliminated mandatory retirement of public employees, including tenured faculty, and, in some states, of private tenured employees as well.

Expected Faculty Retirement Ages

The Committee on Mandatory Retirement, formed by the National Research Council, was charged by Congress to examine the potential effects on colleges and universities and faculty members of ending the exemption for tenured faculty under the Age Discrimination in Employment Act. A key question facing the committee in advising Congress was, What would faculty retirement rates be if the mandatory retirement age for tenured faculty were uncapped as scheduled?

On studying prevailing retirement patterns at all public and private colleges and universities, including institutions that had already ended mandatory retirement, the committee concluded that at most colleges relatively few tenured faculty would be likely to work to ages beyond 70, but that a proportion of tenured faculty at a few research institutions would continue: "Most faculty do not choose to work until age 70, although they have the opportunity to do so, and, overall, only a small number of the nation's tenured faculty will continue working in their current positions past age 70." It also concluded that a number of tools, including elements of pension design, are or could be made available to help institutions cope with the end of mandatory retirement. On that basis, the committee reported that little would be gained by higher education if yet another exception to the age discrimination law were legislated.

Retirement Benefit Recommendations

The committee strongly recommended that all colleges and universities should consider changes in pension plan design in light of a careful analysis at the campus level of faculty demographics and needs. Starting with a statement of basic benefit goals, it offered a number of design recommendations. Its major

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retirement benefit recommendations focused on assuring an adequate pension income:

- Assuming a career of reasonable length, a plan should have a benefit goal at retirement, including Social Security, of at least two-thirds of preretirement salary (the plan replacement ratio), and
- A plan should have some means of maintaining the purchasing power of retirement income during the retirement years.

A Range of Replacement Ratios The committee emphasized that it was recommending not a single benefit target, but a range, with a floor or minimum of 67 percent. It noted that its benefit recommendations generally coincided with similar replacement ratios set forth in the Joint Statement of Principles on Academic Retirement and Insurance Plans, by the American Association of University Professors and the Association of American Colleges (AAUP-AAC). But, taking an unusual position, it recommended a maximum. It urged that "universities and colleges offer pension plans designed to provide retirees with a continuing retirement income from all sources equal to no more than 100 percent of their preretirement income."[3]

By stating benefit goals as a range, the committee implicitly acknowledged the very wide variety of plan types (both defined benefit and defined contribution) and benefit levels found in educational employment. In public employee and state teacher retirement systems covering educational employees, it is the defined benefit formulas that vary greatly. And in the several thousand defined contribution plans in higher education, there is considerable variation in plan contribution rates and investment account options, both of which influence actual retirement benefits.

Benefits Related to Service No employer would provide the same pension benefit for an employee with ten years of service as for one with two or three times that. Accordingly, the committee's statement of benefit goals is based on a reasonable career of service. Similarly, the AAUP-AAC pension statement identifies its "two-thirds" goal as applying to "those retiring at the normal retirement age who have participated in the plan for at least thirty-five years."[4]

Length of service affects benefit results differently in different plan types. In defined benefit plans, service is part of the benefit formula. In defined contribution plans, a plan's contribution rate is set at a level that assumes contributions will be made over a career of, say, thirty or thirty-five years. To test the relation between a particular contribution rate and a benefit result, projections are made for various service periods and at various contribution rates and assumptions about investment return. (The before- and after-tax income replacement ratios needed in retirement to maintain a preretirement living standard are described in "Planning for Retirement: Using Income Replacement Ratios in Setting Retirement Income Objectives," *Research Dialogues*, no. 37 [July 1993].)

Portability of Benefits The committee's statement of goals in terms of ranges acknowledged that there are not only significant differences among plans, but differences in ultimate benefits resulting from individual variations in portability history. Many faculty members will earn vested pension credits at more than one institution; where this is the case, the total pension obligation will be shared among successive employers and will not fall on the final employer. Generally, for mobile employees with the same number of job changes, cumulative vested benefits under defined benefit plans will tend to be lower than under defined contribution plans, other things being equal.

Normal Retirement Age The committee did not directly address the question of the first age at which career-based pension benefits will be presumed to be adequate, although a pension plan's benefit goal must be associated with an age at which the goal is to be effectively achieved. For planning purposes, this is usually considered the "normal" retirement age. The AAUP-AAC Statement of Principles notes an additional value of a normal retirement age: "The availability of an adequate retirement income at the normal retirement age will encourage timely retirement." But it defines the age within a broad range: "Plans in which the normal retirement age is set within the age range of sixty-two to seventy-two appear to conform with reasonable practice."[5]

In most pension plans, the normal retirement age is 65, which is also the age at which full Social Security benefits become payable. In defined benefit pension plans, it is the age at which the full formula benefits become payable; full benefits may be paid earlier provided an employee has met a specific service requirement. In defined contribution plans, the normal age is the age at which the plan's career benefit goal is expected to be achieved by the contribution rate that has been set.

For mobile employees with the same number of job changes, cumulative vested benefits under defined benefit plans will tend to be lower than under defined contribution plans, other things being equal.

Maintaining Purchasing Power in Retirement

The committee stressed the importance of maintaining the purchasing power of retirement income: "Colleges and universities cannot meet the goal of providing for their retired faculty without protecting pensions against inflation."[6] Its call for "a *continuing* level of income (i.e., an income that continues to be equal to 67-100 percent of retirement income in real terms), not just an initial level," echoes the recommendation of the AAUP-AAC statement.[7]

Cost of Maintaining Purchasing Power For most pension plans—public or pri-

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vate, defined contribution or defined benefit—the committee's recommendation to maintain full purchasing power, if strictly adhered to, might require significant plan changes and result in substantially higher plan costs. The committee did note that about half of defined benefit plans for faculty members include provisions for regular cost-of-living adjustments.[10] But it acknowledged that these provisions, which are found almost exclusively in state and local government plans, are actually in the form of prescribed annual increments that seldom exceed 2 1/2 percent and in some plans are not compounded.[11] The committee encouraged "states and colleges and universities offering defined benefit plans" to provide "cost-of-living adjustments that more closely reflect the inflation rate."[12]

As a means of funding inflation adjustments (in defined benefit or defined contribution plans), the committee suggested that "indexed investments" would be "one way to provide inflation protection."[13] At present, however, because of public policy, tax, and other issues, indexed loans do not figure among the available debt obligations in the United States. A few such instruments have been offered as pension investments in the past on a limited basis by Canada, Great Britain, and Israel.

Purchasing Power through Annuity Payment Methods The committee report recognized that under defined contribution plans there are a number of annuity payment methods available to help maintain postretirement purchasing power.

> We encourage faculty covered by defined contribution plans to take advantage of annuity payment options designed to adjust for inflation, and we encourage the organizations that administer defined contribution plans to seek better ways to protect pension incomes from inflation.

Inflation-hedging options under defined contribution pension plans include traditional annuities with special payment methods and variable annuities based on equity investments. Variable annuities can directly link pension income with the investment objectives and experience of specific equity asset accounts, although not directly with inflation rates themselves.

Graded Payment Method One traditional annuity option that is expressly designed to help protect retirement income against inflation is the TIAA Graded Payment Method, available to participants under the traditional TIAA retirement annuity, and elected at the time of their retirement. The graded method doesn't directly correlate with annual inflation changes. But it does incorporate an annual benefit increase that is roughly equal in percent to the difference between 4 percent (the annuity's assumed interest rate, or AIR) and the prior year's payout annuity dividend interest rate. And increased rates of inflation may lead to increased rates of interest. (In 1993, 12.6 percent of male retirees and 8.4 percent of female retirees elected the graded method when they started TIAA benefits.)

The graded method is similar in certain respects to the committee's proposal to use indexed bonds to protect annuity purchasing power. Annuities based on bonds indexed to inflation could produce each year an annual benefit increase exactly equal to the inflation rate.

Inflation protection, of course, comes at a cost. For the protection provided through the TIAA graded method, the cost can generally be described as the difference in initial benefits between the graded method and the standard method. Under the graded method, retirees start their income at a level in the initial year that is lower than the income that would be payable under the standard payment method. The reduction reflects the difference between benefits paid at the assumed interest rate of 4 percent compared with the current total effective payout rate of the standard method.

A higher overall graded benefit could be achieved by increasing a plan's contribution rate. A higher accumulation at retirement would raise the initial graded benefit to a higher level, but this would increase plan costs. The committee report cautioned that "any changes a college or university makes in its retirement benefit policies should be within the bounds of its current faculty compensation budget."[14]

Performance data show that when diversified common stock investments are accumulated and paid out over long periods, total rates of return can be favorable compared with other choices.

Variable Annuity Accounts A part of the design of defined contribution plans is the option for participants to allocate pension contributions to different investment accounts, including fixed-income investment and equity-based funds. Performance data show that when diversified common stock investments are accumulated and paid out over long periods, total rates of return can be favorable compared with other choices. When variable annuity income payments reflect positive long-term economic growth, the potential for inflation adjustment is increased.

A defined contribution pension plan that provides a range of choices for annuity accounts gives participants direct responsibility for choosing their own asset diversification. Clearly, participants will not all make the same choices or experience identical investment results. The implication of this for benefit plan designers and managers is the knowledge that at retirement, some otherwise equally situated participants may find their benefits at the low end of a plan's income (and inflation-protection) potential, while others may be at the high end.

When Benefits Exceed Goals

The committee reflected a concern of educational administrators that pension benefits for long-service faculty might rise to levels that could act as an incen-

tive to delay retirement in order to gain further benefits. It noted that under defined benefit plans, both the service and the salary factors in the benefit formula increase as age advances. And in defined contribution plans, benefit amounts can increase each year retirement is delayed, because of the full annuity accumulation's continued investment earnings and its growth from continued plan contributions, as well as because of the decreasing life expectancy factor.

Employees thinking about retirement can be expected to compare their health-care coverage as employees with their coverage as potential retirees.

On the other hand, if retirement benefits at a preferable retirement age are inadequate or only barely adequate, deferred retirement, welcome or not, can help improve future retirement income security. Such low benefits may be due to an interrupted work career in prior years; pension accumulations previously cashed out prior to retirement; prior participation in plans providing low benefits; failure to vest under prior plans; or poor choices among the investment, allocation, and transfer options under a current or prior plan.

Placing Limits on Benefits. As a way of making retirement decisions more neutral, the committee proposed placing limits on benefits, especially at research institutions with generous contribution rates, where faculty might choose to delay retirement. Under defined benefit plans, for example, concerned institutions could consider slowing benefit growth by placing limits on the years of service to be taken into account in the benefit formula, or by setting a percentage limit on the proportion of final salary that would be paid under the plan.[6] Some plans already have limits. According to a 1987 report, 26 percent of sixty-four major public (defined benefit) retirement systems covering colleges and universities incorporated a limit on the replacement ratios payable.[7]

The committee acknowledged that suggestions to limit contributions under defined contribution plans raised problems of possible discrimination: "Because limits to contributions disproportionately affect older faculty, it is unclear whether such limits violate age discrimination law."[8] But it recommended that Congress and regulatory agencies such as the Internal Revenue Service and the Equal Employment Opportunity Commission "adopt policies allowing employers to limit contributions to defined contribution plans on the basis of estimated level of pension income."[9]

Voluntary Retirement Incentives

In an era without mandatory retirement, the committee recognized, employers would under certain conditions want to encourage voluntary retirements through special incentives. Incentive programs, it concluded, "are clearly an important tool for increasing turnover and one that must be considered by any college or university concerned about the effects of retirement."[10] As the committee observed, incentive programs can (1) help reduce overstaffed fields or departments; (2) incorporate limits on participation in the voluntary programs as a means of controlling turnover and costs; and (3) offer flexible opportunities to faculty for partial or phased retirement.

To clarify the rules for such programs, which have been established by a number of institutions, the committee recommended that

> Congress, the Internal Revenue Service, and the Equal Employment Opportunity Commission permit colleges and universities to offer faculty voluntary retirement incentive programs that: are not classified as an employee benefit, include an upper age limit for participants, and limit participation on the basis of institutional needs.[11]

Retirement incentive programs must be truly voluntary and not forced onto employees. The committee emphasized this principle, and urged that programs be designed for freedom of choice and be regarded by both the institution and the individual as mutually beneficial. It noted that the Older Workers Benefit Protection Act of 1990 allows an employer to set a minimum age for participation in retirement incentive programs.[12] The committee recommended that institutions that offer retirement incentives extend them only to those who are ready to consider seriously when to retire, and that for tenured faculty, such programs be offered only for those age 50 and over.[13]

In outlining various incentive approaches, the committee encouraged institutions to consider a range of possibilities, including financial arrangements for partial, phased, and full retirement, as well as the following financial benefits[14]:

- Lump-sum severance payments
- Additional credits under defined benefit plans
- Annual payments for specified periods from the institutional budget equal to full preretirement salary or a percentage of it
- Institutional purchases of supplemental annuities

In developing retirement incentive programs, the committee urged that employers be aware of and take into account the various federal and state tax laws that affect incentive programs and their benefits.[15] (For information on developing early retirement incentive programs in educational institutions, see TIAA-CREF, "Special Report," *Benefit Plan Counselor* [April 1993] and "Voluntary Incentive Early Retirement Programs," *Research Dialogues*, no. 18 [July 1988, updated and reprinted August 1992].)

The committee also noted that state governments at times offer retirement incentive programs to state employees. Where this is the case, the committee recommended that consideration be given to the impact of such programs on public higher education institutions.[16]

Health-Care Coverage in Retirement

The committee recognized that the economic aspects of a decision to retire rest not only on pension income, but also on the adequacy of retiree health-care coverage.[8] The close link between *income* security and *health-care* security is very evident; employees thinking about retirement can be expected to compare their health-care coverage as employees with their coverage as potential retirees.

As the committee noted, "Inadequate or expensive retirement health coverage creates a disincentive to retirement. Institutions can give retirees additional financial security by providing retirement health care coverage."[9] (The effect of employer-sponsored retiree health insurance on decisions to retire is described in "Influence of Employer-Provided Retiree Health Insurance on Retirement Decisions," *Research Dialogues*, no. 38 [September 1993]. And the extent of employer-sponsored retiree health-care insurance in educational institutions is reported in "Survey of Group Health-Care Plans for Retired Employees of Colleges, Universities, and Independent Schools," *Research Dialogues*, no. 36 [March 1993]. This survey indicates that there has been a decline over the past five years in the proportion of educational employers who provide health-care coverage for retirees.)

Medicare does not cover retired employees under age 65. For retirees 65 and older, the committee observed that Medicare is not nearly as comprehensive as the health-care coverage an employee usually has while working. Consequently, employees may hesitate to retire if health-care coverage for employees is better than coverage for retirees. It is expected that national health-care reform proposals will consider an overall plan for the health-care coverage of retirees.

Perquisites for Retired Faculty

Retirement is almost invariably a process that is personally difficult. Psychologists rank it among the ten most stressful personal events. While having adequate retirement income and health-care coverage makes retirement economically feasible, the economic aspects don't totally determine the decision. Personal considerations are also important. Here too, employers can provide help.[10]

The committee recognized that retirement—particularly for professional people—can mean leaving an active and productive career, a supportive institution, valued colleagues and students, useful facilities, and the personal prestige of holding a recognized position in the educational and research community. To ease the transition, the committee recommended that all colleges and universities assist their faculty in planning for retirement. In addition, the committee recommended that they enhance opportunities for their retired faculty to maintain links with the academic community:

> Faculty members who are considering retirement may be reluctant to give up regular contact with students and colleagues or such faculty privileges as access to a laboratory or library. Colleges and universities can offer some continued faculty perquisites as a way to make retirement more attractive. At the same time, retired faculty can continue to contribute to the life of their college or university. Many perquisites, such as office space, entail significant costs to colleges and universities, but others, such as invitations to events, involve little or no marginal cost.[11]

While having adequate retirement income and health-care coverage makes retirement economically feasible, the economic aspects don't totally determine the decision.

Conclusion

In legislating exceptions for tenured employees to the Age Discrimination in Employment Act, Congress was responding to concerns that without mandatory retirement, tenure and low turnover could make it difficult for colleges and universities to hire new faculty as a source of new ideas and new research directions. Later, in recommending that Congress allow the last of the exceptions to expire at the end of 1993, the Committee on Mandatory Retirement concluded that during their existence, the exceptions had substantially aided the colleges over a transition period. It also concluded that changes in pension design are needed to help higher education "adjust to the elimination of mandatory retirement without significant effects."[12]

Retirement age patterns and pension plan goals are closely related. The committee recognized that with the end of mandatory retirement, a review of existing pension goals and provisions is appropriate. The committee's recommendations regarding basic plan provisions included benefit goals, inflation-adjustment mechanisms, limits on benefits, incentives for voluntary early retirement, retiree health-care coverage, and amenities for retired faculty.

Concluding its report, the committee noted that eliminating mandatory retirement can have beneficial results. "Most obviously," it said, "faculty gain freedom in deciding when to retire. Eliminating mandatory retirement would also be in keeping with the general intent of the Age Discrimination in Employment Act to extend protection against age discrimination."[13]

(This report was prepared for Research Dialogues *by Frances P. King, Senior Research Officer, TIAA-CREF.)*

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Endnotes

[1] The members of the Committee on Mandatory Retirement in Higher Education were Ralph E. Gomory (Chair), President, Alfred P. Sloan Foundation; Norman M. Bradburn, University of Chicago and National Opinion Research Center, Chicago; David W. Breneman, Harvard University; F. Albert Cotton, Texas A&M University; Mary W. Gray, American University; Donald C. Hood, Columbia University; Robert M. O'Neil, University of Virginia and The Thomas Jefferson Center for the Protection of Free Expression, Charlottesville, Virginia; Robert E. Parilla, Montgomery College; and Mitchell W. Spellman, Harvard Medical School. P. Brett Hammond was the Study Director and Pamela Ebert Flattau, Study Codirector.

[2] P. Brett Hammond and Harriet P. Morgan, eds., *Ending Mandatory Retirement for Tenured Faculty*, Committee on Mandatory Retirement in Higher Education, Commission on Behavioral and Social Sciences and Education, National Research Council (Washington, D.C.: National Academy Press, 1991), 29.

[3] The statement is printed in American Association of University Professors, *Policy Documents & Reports* (Washington, D.C.: American Association of University Professors, 1990), 173-78.

[4] Hammond and Morgan, *Ending Mandatory Retirement*, 69.

[5] American Association of University Professors, *Policy Documents & Reports*, 174.

[6] Ibid., 174.

[7] In 1991, 20.8 percent of TIAA-CREF participants started annuity income at 65; 40.2 percent at 56 to 64; 20.1 percent at 66 to 69; 15.7 percent at 70 and 71; and 3.1 percent at 72 and over. See "Voluntary Incentive Early Retirement Programs," *Research Dialogues*, no. 18 (July 1988), reprinted and updated August 1992.

[8] Hammond and Morgan, *Ending Mandatory Retirement*, 69.

[9] American Association of University Professors, *Policy Documents & Reports*, 174.

[10] Hammond and Morgan, *Ending Mandatory Retirement*, 80-82.

[11] A recent study of public employee retirement systems (state and local), including plans for teachers, found that 51 percent of full-time participants are in defined contribution plans with automatic cost-of-living increase adjustments. The study notes that in 95 percent of the 51 percent of the plans, the annual automatic COLAs are subject to maximum amounts that center around 2 or 3 percent. William H. Crown, Phyllis Mutschler, and James J. Callahan, Jr., *Pension and Health Benefits for State, Local, and Teacher Retirees Coping with Inflation—1982-1987* (Waltham, Massachusetts: The Policy Center on Aging, Heller School, Brandeis University, 1991), 11.

[12] Hammond and Morgan, *Ending Mandatory Retirement*, 82.

[13] Ibid., 81.

[14] Ibid., 82.

[15] Ibid., 68.

[16] Ibid., 79.

[17] *Summaries of Public Retirement Systems Covering Colleges and Universities* (New York: TIAA-CREF, 1987), 8.

[18] Hammond and Morgan, *Ending Mandatory Retirement*, 80.

[19] Ibid., 80.

[20] Ibid., 99.

[21] Ibid., 96, 99.

[22] Ibid., 100.

[23] Ibid., 96.

[24] Ibid., 100.

[25] Ibid., 93.

[26] Ibid., 95-98.

[27] Ibid., 98.

[28] Ibid., 85.

[29] Ibid., 109.

[30] Ibid., 85.

[31] Edward A. Charlesworth and Ronald G. Nathan, *Stress Management* (New York: Ballantine Books, 1984), 178.

[32] Hammond and Morgan, *Ending Mandatory Retirement*, 90.

[33] Ibid., 89.

[34] Ibid., 109-10.

[35] Ibid., 110.

[36] Ibid., 110.

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